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IN THE

Supreme Court of the United States

October Term, 1949.

No. 735

EMILY MARX, *et al., Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE.

Petition for Writ of Certiorari and Brief in Support Thereof.

EMILY MARX,
Attorney for Petitioners.

LODER APPEAL PRESS, INC., 65-67 Duane St., N. Y. C., Tel. WOrth-2-0689

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1949.

No. .....

EMILY MARX, *et al., Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE,

PETITION FOR A WRIT OF CERTIORARI.

Petitioners[1] pray that a writ of certiorari issue to review the judgment of the Court of Appeals for the First Circuit.

Opinions Below.

The opinion of the Tax Court (29-41) is not officially reported. The opinion of the Court of Appeals (125-32) has not yet been reported.

Jurisdiction.

The judgment of the Court of Appeals was entered on February 7, 1950 (132). The jurisdiction of this Court is

1. These are two Tax Court proceedings, consolidated for trial over petitioners' objection (52) and on appeal at petitioners' request (124). Petitioners are Emily Marx (herein sometimes referred to as EM) in one case and Emily Marx and Victor House (herein sometimes referred to as VH) in the other. TR references are to the pages of the original Tax Court record, read by the court below (132) and on file with the Clerk of this Court.

invoked under 28 USC 1254(1), 2101(c) and 26 USC 1141(a).

Questions Presented.

(1) Whether a notice of deficiency, patently in excess of respondent's statutory powers and conceded by the Court of Appeals to be obviously arbitrary on its face and invalid, tolls the statute of limitations upon assessments of income taxes.

(2) Whether the jurisdiction of the Tax Court is limited to adjudication of the issues raised by the notice of deficiency, the petition and the answer.

(3) Whether a notice of deficiency, patently in excess of respondent's statutory powers and conceded by the Court of Appeals to be obviously arbitrary on its face and invalid, casts upon the taxpayer the burden of supporting every deduction claimed in his return against every objection that may possibly be made thereto under the statute and, if so, whether the taxpayer is entitled as of right to a rehearing to meet such objections after the Tax Court's opinion has for the first time stated them.

(4) Whether section 5(a) of the Administrative Procedure Act[2] applies to respondent; whether it applies to the Tax Court; and whether section 10(e)(B) applies to the Court of Appeals in its review of tax court decisions.

Statement.

These actions, instituted by petitions filed on July 24, 1947 in the Tax Court pursuant to *IRC* 272(a), concern respondent's determinations of deficiencies in income taxes for the years 1940 and 1941 made "merely to toll the statute of limitations"[3] and after petitioners had refused to

2. 5 *USC* 1001 et seq., herein sometimes referred to as *APA*, approved June 11, 1946.

3. The notices of deficiency were mailed on May 2, 1947.
The making of such determinations by respondent was one of the major evils brought to the attention of Congress by the Attorney General's Committee on Administrative Procedure. Sen. Doc. #10(9), 77th Cong., 1st sess., p. 16-7 (1941).

agree to a fourth extension of the limitations period. The questions presented on this petition for a writ of certiorari arise in both actions; for brevity, this factual statement will be confined to the 1940 notice of deficiency.[4] Such notice was issued after four field examinations of petitioner's cancelled checks[5] (57, 75, 4, 54), a written protest against respondent's preliminary[6] deficiency determination (6), two hearings[7] before respondent's conferees (6), and three concomitant examinations (73) of the 1935 through 1946 records and returns of The Houses, Inc., a New Hampshire real estate corporation equitably owned by petitioners' minor children (35), against which

4. The issues between EM and respondent were identical in each action and differed from those between VH and respondent. The facts were presented to the Tax Court separately for each year, in accordance with petitioners' request and that court's direction (52). If the instant petition is granted, petitioners will argue to this Court that the 1941 proceeding involved the same violations of law. For a graphic example of complete abandonment by respondent and the Tax Court of the issues raised by the pleadings in the 1941 proceeding, see the Appendix to the annexed brief.

5. The examinations were held on June 30, 1943, June 28, 1944, October 6, 1944 and April 17, 1945 (57). Each of the cancelled checks bore on its face a detailed notation of the item covered, with notice to the payee that endorsement constituted receipt in full for such item. In making such multiple examinations, respondent violated *IRC* 3631.

6. Known as respondent's 30-day letter, dated Jan. 30, 1946, this contains the examining agent's report of the reasons for the proposed changes in the filed return, resulting in the claimed deficiency in tax. The written protest must attack the 30-day letter in exactly the same way in which the Tax Court petition must attack the notice of deficiency, except that on a protest the taxpayer must give all his factual evidence to respondent. 11 *Fed. Reg.* 177A-38, 44; 26 *CFR* 601.2 (c-1); 601.3 (6); Sen. Doc. #10, *supra* footnote 3, p. 12-3. The instant notice of deficiency merely confirmed the preceding 30-day letter, differing only in the use of more equivocal language (TR. 365, aff. K, p. 2). Petitioner's protest was filed on February 25, 1946 (6).

7. Held on April 2, 1946 and March 27, 1947 (long after the effective date of *APA*), at which respondent purported to inform petitioner of all his objections to the filed return and to give petitioner the opportunity to meet them; and at which petitioner complied with respondent's published *Conference and Practice Requirements, Bureau of Internal Revenue*, IX (11 *Fed. Reg.* 177A-38): "In order that the case under consideration may be closed at one conference, if at all possible, *** (the requirements) that the brief submitted in advance of conference must meet all issues raised will be strictly enforced, and another conference will not be granted on the same case except to meet new issues raised by the Bureau in the course of the first conference which could not have been anticipated prior to such conference."

no deficiency was asserted although originally[8] claimed (52).

The notice of deficiency—mailed two months before the expiration of the statutory limitation period as thrice extended—made "adjustments" in petitioner's filed return of which the following are typical examples:[9]

(1) Disallowed *all* business expenses and *all* depreciation on office furniture "in the absence of adequate and complete records * * * inasmuch as no competent evidence or appropriate information has been submitted in substantiation thereof" (7), and taxed as net income the entire reported "total receipts" (42) in which were included "*all* funds received from clients for future as well as past disbursements, fees and retainers, her salary as a Justice * * * and income from the sale of books" (31).

(2) Disallowed a dependency credit for one of petitioners' two infant children (42) "as (she) was not your dependent during 1940 under the provisions of the Internal Revenue Code" (7), but allowed the claimed dependency credit for the other infant child (42).

The petition which, under the rules of the Tax Court was *required* to confine itself to the notice of deficiency, stating the specific errors claimed to have been made by respondent in his determination and the facts upon which petitioner relied to sustain each of these claimed errors (*RTC* 7), alleged with respect to such "adjustments":

---

8. By 30-day letter similarly dated Jan. 30, 1946 (TR 395, aff. M). See Appendix to annexed brief.

9. It was one of those "so vague" notices, another major evil to which the Attorney General's Committee drew the attention of Congress (*supra* footnote 3, p. 75-6). Annually since the year 1941, the American Bar Association has petitioned Congress to amend *IRC* 1111 to permit the Tax Court to require "that the Commissioner state in writing clearly and completely the grounds upon which the deficiency is proposed." 3 *Hearings on Proposed Revision of IRC*, 80th Cong. 1st sess., 1789 (1947). *Cf. Helvering v. Tex-Penn Co.*, 300 U.S. 481, 498 (1937): "The taxpayers were entitled to know the basis of law and fact on which the commissioner sought to sustain the deficiencies." In his brief to the instant court below, the respondent argued that "the Commissioner's determination must be sustained by the Tax Court on any appropriate theory *whether or not articulated in the deficiency notice.*"

(1) That the assessment of an income tax on gross office receipts and the disallowance of all office expenses and all depreciation on office furniture was a violation of *IRC* 11 and 12 (3); that competent evidence and appropriate information had been submitted by petitioner in substantiation of such expenses and depreciation (3) in that

(a) Cancelled checks in substantiation of each of the claimed business expenditures—"spent in the operation of her law offices" (3)—and a tabulation of such checks with the name of the payee, the amount and the general purpose of each, had been exhibited on four separate occasions to respondent's named agents (4); but that such agents had claimed that the cancelled checks and tabulation thereof were not sufficient and that "permanent books of account were required to substantiate office expenses" (4), although for the past twenty years respondent's agents had accepted such checks and tabulations "as sufficient substantiation of office expenses for income tax purposes" (4). A copy of the tabulation was annexed to the petition (8-10).

(b) The office furniture and equipment depreciated and the total amount taken for depreciation for the year 1940 were identical with that approved by respondent's agent in writing for the year 1939 (4); and that no agent of respondent had ever requested of petitioner a substantiation of the depreciation claimed in her 1940 return (4-5).

(2) That said infant child was dependent for her support upon and received her entire support from petitioner—with whom she lived—and had no separate income legally available for such purpose (3, 5).

Respondent's answer (12) which, under the rules of the Tax Court was required to fully and completely advise petitioner of the nature of his defense to the allegations of the petition (*RTC* 14), "consisted of nothing more than

a series of denials of each and every allegation contained in the various numbered paragraphs of the petition".[10]

In her opening in the Tax Court petitioner sought to raise the point that the entire notice of deficiency was "so obviously arbitrary" that it must be set aside; but the trial judge said: "I don't want to hear the law and I am not going to listen to the law. State what you expect to prove" (54). The issues as to the above "adjustments" were stated by counsel to be as follows:

By petitioners: "Whether the Commissioner may tax all receipts reported by the taxpayer from her law practice and disallow(ed) every single disbursement (53-4). I expect to show that the taxpayer's records were subjected to four examinations without the taxpayer's request and without the written notice from the Commissioner that the statute requires (54); that the entire gross receipts were taxed and no disbursements permitted, although there was ample proof of it and the proof was delivered to the agent (54). That the same items on which depreciation is claimed for the year 1940 were allowed for the year 1939 in the report of the agent, and after a 30-day letter from the Internal Revenue Agent in Charge (54). (That) the 7-year-old daughter of the petitioner received her entire support from the taxpayer" (53).

By respondent: "Merely a cursory glance down the items in (the schedule attached to) that petition will show that every item requires the closest scrutiny (55). It will be necessary to analyze those items. Those are set up as expenses to be deducted from income. That will be quite a problem (55). There is a question of deduction

10. The filing of such answers was another major evil brought to the attention of Congress by the Attorney General's Committee (*supra* footnote 3, p. 74-5). The Tax Court has consistently refused to require respondent to amplify his answers, although its rule 18 gives the appearance of entitling a taxpayer to such amplification. CCH, *Procedure & Practice before the Tax Court*, 96-7 (1950). At the instant trial, the Tax Court confirmed that it did not require respondent to admit allegations in the petition which he did not in fact controvert (58).

for the so-called dependent daughter (55-6). Our information is that in 1940 that daughter had an income in excess of $9,000 under a trust and unless it can be shown that that was less than 50% of what was expended for the child's support, there can be no rightful deduction for dependency" (56).

By petitioners: "It is not true that this infant had expendable income of any kind. The money has never been in my hands. I have never seen it. I reported it every year on the theory of constructive receipt" (56).

The first trial judge said that he didn't "care" and was "not interested right now" in whether petitioner's cancelled checks had been examined by respondent's agents 58). After respondent had again examined petitioner's cancelled checks (at the court's direction) and had conceded that there was a cancelled check for every claimed expenditure, that "the items listed in the Exhibits (8-11, 21-26) attached to the petitions have been paid out by the petitioners" (60), and the trial was continued before another judge, petitioner again claimed that the notice of deficiency was obviously arbitrary on its face and therefore invalid (67) and again sought to testify as to such prior examinations. Respondent's objection to such testimony was sustained by the trial judge after the following colloquy (67-8):

> "The Court: That is irrelevant and immaterial. Whatever your prior dealings with the Internal Revenue Agents is not relevant in this proceeding at all.
>
> Miss Marx: Except your Honor, I think that here there was no reason, unless the Government will withdraw the statement that we did not substantiate our expenses—if they will withdraw.
>
> The Court: No, that is what you are doing now, is to substantiate it.

> Miss Marx: I say they were substantiated from the beginning.
>
> The Court: I say that is immaterial. Because now the question is, are they substantiated in this proceeding, and you are doing that right now. *Whether they were substantiated before doesn't make any difference.* * * * *If they were substantiated before a Revenue Agent, but are not substantiated here in this proceeding it does not make any difference.*[11] You are bound by the record here."

And so the Tax Court forced petitioner—who was under respondent's subpoena (27, 73-4)—to explain every item of business expense paid out eight years before the trial,[12] while respondent gave "every item the closest scrutiny" (55). For what purpose he did not disclose except to state to the Court that he was *not* arguing "as to the merits of these deductions" (TR 40, p. 191). In the middle of the trial, petitioner again tried to return to the pleadings (68):

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11. "The Court: This is a trial de novo. None of the preliminary negotiations are relevant whatsoever" (TR 40, p. 78). See footnotes 28, 29 *infra*.

12. Petitioner, being a lawyer admitted to practice before the Treasury Department, was willing to give respondent "an explanation" of the checks listed in the Exhibits attached to the petitions (129) solely in performance of what she believed to be her professional obligation to the court on returns sworn to by her, although by that time the thousands of cancelled checks, which explained their purpose on their face, were no longer in court. At no time did respondent or even the tax court suggest that there was now an issue of non-deductibility under *IRC* 24(1)—read into the pleadings by the Court of Appeals (132)—until respondent filed his brief three months after the conclusion of the trial. That issue was squarely met in the affidavits filed in support of the motions for rehearing (TR 365, 395). The objection of non-deductibility under *IRC* 24(1) was raised in the notices of deficiency *only* as to a trifling New York City water tax (7). In order to sustain its decision, the Tax Court was forced to put words into respondent's mouth (31) that he did not utter (59-60) until three months after the trial. That respondent did not himself know what he was claiming and that he was *not* claiming non-deductibility under *IRC* 24(1) when he asked for "an explanation" of the checks listed in the Exhibits attached to the petitions (60), appears clearly from the list of checks which he told the court "we do not recognize are proper deductions" (59). Among "the balance (which) require explanation which I assume will be given" (59-60) were checks for petitioner's office rent (22), paid to the same landlord to which respondent was then paying rent (6). He "recognized" those checks only after petitioner testified thereon (TR 40, p. 175-6).

"Miss Marx: In connection with the year 1940, I would like to offer the same testimony I tried to offer in '41, as to exhibiting of checks and I assume that your Honor will rule similarly." Respondent again objected to such testimony and his objection was again sustained with an exception to petitioner (68). And again, petitioner pointed out that the notice of deficiency "attempts to tax the gross receipts without any allowance at all for any deductions" (68). At the conclusion of the trial—at page 263 of the 265 page Transcript of Testimony (TR 40)—petitioner again sought to present evidence "of the many times in which the returns, all the returns and reports, all the records of the taxpayers mentioned here, have been examined since they were filed with the Government" (75). But the trial judge again sustained respondent's objection to such testimony, again granting petitioner an exception (75).

Although petitioners' brief to the Tax Court claimed —as petitioners had claimed throughout the trial—that the main issue was "whether the Commissioner's notices of deficiency were arbitrary and excessive and therefore invalid as a matter of law" and that "this court should have entered a decree of no deficiency upon petitioners' application at the commencement of the trial",[13] no mention of such issue was made in its opinion. Nor did it mention petitioners' briefed claim that respondent's answers violated rule 14 of the Rules of the Tax Court and section 5(a) of the Administrative Procedure Act and should have been stricken out. The Tax Court treated the cases as if respondent's determination had been that all the claimed business expenses were non-deductible be-

13. On the day preceding the opening of the trial, petitioners moved to dismiss the notices of deficiency and for decrees of no deficiencies on the ground of their invalidity as a matter of law; and respondent moved to consolidate the two actions. Petitioners' motion was summarily denied and decision was reserved on respondent's motion. No stenographic record was made of those motions, apparently (52).

cause "personal" within the meaning of *IRC* 24(1) and as if petitioner had not itemized in detail—as was done both in the filed return and in the filed petition—the amounts expended for "rent, repairs and other expenses".[14] It allowed approximately three-fifths of the claimed business expenses[15] and completely ignored the claimed office furniture and equipment depreciation (43; TR 365, aff. C, p. 3). It denied without opinion, petitioner's motion for a rehearing to enable her to show that all the disallowed expenses were business expenses and not personal expenses (TR 365, aff. C).

On the dependency issue, petitioner testified (69): "During the year 1940, I supported my daughter Janet in our home. She received no support from any other place. She was seven years old at the time. Although she had a trust income it was never received by me or used by me for anything connected with her support. Never physically received by me either". On cross-examination, petitioner testified: "I agree that during those years (1940 and 1941) she (Janet) constructively received the IRC fiduciary income of those amounts ($7000 and $4000), yes" (70), that neither petitioner made any effort to have any of that income used for the infant because "it would be against the law" (71). In his post-trial brief to the Tax Court, respondent referred to VH's testimony in the *1941* proceeding (84-5)—that this 7-year-old infant lived in his home with him, that he used none of her funds for the purpose of housing and feeding her and that she obtained none of her support from any source except the funds of himself and his wife (EM)—and concluded: "Presumptively the father would support the child under the evidence, and the mother therefore would not be en-

14. Note that the filed return broke down the item "rent, repairs and other expenses" into its various parts, as required in respondent's income tax form (42), but that the notice of deficiency completely ignored such break down (7).

15. 59% of the business expenses claimed by EM for 1940 and 68% of those claimed by her for 1941 were allowed by the Tax Court.

titled to the dependency credit.[16] A joint return was filed for 1941 and respondent concedes the credit[17] should be allowed for that year." Whereupon, the Tax Court found as a fact that during 1940 the infant received her chief support from VH (36). On a motion for a rehearing, VH stated under oath that he made no contributions whatever to the household expenses of his family during the year 1940, that all such expenses were paid by EM out of her personal funds and that the infant received her entire support and maintenance from EM. EM made a similar sworn statement (46). The motion for rehearing was denied without opinion.

And thereupon respondent brought this petitioner into the Tax Court again, on *identical* notices of deficiency for the years 1942 and 1943. This time, on similarly itemized petitions and similarly noncommittal answers, the tax court merely incorporated in its opinion the lump sum allowances for business expenses suggested in respondent's brief to it, after indicating in a general way that the few items specifically allowed in the 1940 and 1941 cases were clearly not deductible expenditures and that the depreciation on office furniture and equipment was equally clearly deductible since "in line with what she claimed and was allowed in previous years". And, although respondent had read into that record the testimony on which the court had made its 1940 factual finding on the de-

16. Just how it would be possible for one of two infant children to be supported by their mother and the other by their father, where both are living in the same household, living, sleeping and eating together with their parents, is hard to understand. In conceding in his notice of deficiency that the mother was entitled to the dependency credit for their infant son (42), respondent tacitly conceded as well that the mother was paying the household expenses. The only question ever raised by respondent as to this dependency credit was one of law, i.e. whether the child's fiduciary income prevented its being a statutory dependent (TR 365, affs. K, A).

17. Which was specifically claimed for that year by the mother, petitioner EM, and not by the father, petitioner VH (43). In failing to consider each case separately and in using the 1941 testimony to raise a "presumption" against the veracity of the 1940 testimony, the Tax Court's finding on the 1940 dependency credit was "improperly grounded." *U.S. v. Pierce Auto Lines*, 327 U.S. 515,528 (1946).

pendency credit for petitioner's infant daughter, it held that petitioner was clearly entitled to that credit for the years 1942 and 1943.[18]

The instant Court of Appeals eliminated (130) the notices of deficiency from the pleadings,[19] held that the issues were made by the petitions and answers, which "clearly present the full issue of whether or not the payments claimed were actually made, and if made, whether they were properly deductible" (130)—"whether they were made for business purposes or for personal use" (132)—and that, if petitioner "did not in fact understand, and was not prepared to try the only issue left in the case by the concession of the Government, *i. e.*, the issue of deductibility of some of the payments concededly made, which seems inconceivable, she has no one to blame but herself" (130). It apparently conceded that each of the notices of deficiency "is obviously arbitrary and excessive on its face" (130) but held that under *Helvering* v. *Taylor*, "an arbitrary determination of deficiency by the Commissioner is not void and therefore a nullity. Such a determination is invalid, and if invalidity on that score can be established by the taxpayer, ground for redetermination by the Tax Court has been established" (131).

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18. Marx v. Com., 13 TC #136 (1949), notice of appeal filed 3/3/50. There the court said in answer to petitioner's claim that the notices of deficiency were patently in excess of respondent's statutory powers and obviously arbitrary on their face and therefore void: "I never heard of any such theory" (Transcript of Testimony, p. 112). In the middle of that trial, respondent conceded that the distributive share of fiduciary income that he had added to petitioner's 1940 and 1941 returns (7, 19)—which resulted automatically when in 1944 respondent adjusted the fiduciary's returns by shifting some of its 1942 and 1943 income to 1940 and 1941 and to which adjustment the fiduciary made no objection since the additional tax to it thereunder was merely $14 (TR 40, p. 180-1)—was the same distributive share on which petitioner had paid a tax for the years 1942 and 1943 and that his deficiency notices for the latter years were erroneous in attempting to tax her with this same income four times. Since that concession was made before the instant record was prepared, that further example of the obviously arbitrary character of the instant notices of deficiency was omitted from petitioners' appendix (13). But see TR 365, p. 1; TR 395, aff. C.

19. Cf. Sen. Doc. #10, *supra* footnote 3, p. 75: "In a sense the first pleading in a Board proceeding is not the taxpayer's petition, but the Commissioner's statutory notice of deficiency."

It apparently conceded that the "issue of deductibility" was *not* raised in the *notices of deficiency* (130). It expressed no opinion on the applicability of the Administrative Procedure Act.[20] It classified the other issues raised[21] as "factual in their nature", as to which "the entire record clearly establishes a firm basis in the evidence for every finding of fact made by the Tax Court" (132). It expressed no opinion on whether such findings of fact were made dehors the issues raised by the pleadings, as petitioners claimed, and ended up with a pat on the back for the Tax Court (130) and a blow below the belt[22] for petitioners (132).

Reasons for Granting the Writ.

Congress hoped that the Administrative Procedure Act would end the major abuses to which taxpayers have been subjected by the kind of notices of deficiency, tax court trials and court of appeals decisions shown in the instant record. The Act was intended to be "a bill of rights for the hundreds of thousands of Americans whose affairs are controlled or regulated in one way or another by agencies of the Federal Government",[23] including the 52.8 million Americans who file individual income tax returns.[24] If Congress has failed to eliminate those major

20. After the *Sung v. McGrath* decision by this Court (Feb. 20, 1950), petitioners moved for leave to reargue the applicability of APA (134). The motion was denied without opinion (135).

21. A copy of petitioners' brief to the Court of Appeals has been filed with the Clerk of this Court. The other issues raised to the court below are cumulative examples of the same procedure followed by respondent and the Tax Court on the two "adjustments" herein discussed.

22. Usually the last resort of a fighter about to go down for the count.

23. Sen. Doc. #248, 79th Cong. 2nd sess., p. 298 (1946). "It (*APA*) is more complete than the solution favored by the majority of the Attorney General's Committee." Idem., p. 303. "It represents an outline of minimum basic essentials, framed out of long consideration and in the light of the comprehensive studies (Sen. Doc. #10, *supra* footnote 3)." Idem., p. 304.

24. Of these, 10.5 million taxpayers show total receipts or other figures requiring deduction of expenses before statutory gross income can be determined. Treasury Dept., *Statistics of Income for* 1946, Part 1 (1949).

abuses, it should be so informed by this Court forthwith, so that it may enact more potent legislation. If it has not failed, respondent, the tax court and the courts of appeals should be so informed by this Court forthwith, so that these abuses will not be continuously repeated.

Contrary to repeated decisions of this Court and in disregard of the provisions of the Administrative Procedure Act, the court below has held that the determination of an administrative official, invalid because obviously arbitrary on its face, has the same statutory effect as a valid one. Even if this holding is restricted to determinations of respondent, it is one of such importance under the Internal Revenue Code and the Administrative Procedure Act that it should be reviewed by this Court.

Respondent's statutory powers are limited. Insofar as here pertinent, the mailing of his determination that there is a deficiency in income tax tolls the statute of limitations, which would otherwise irrevocably establish the tax computed by the taxpayer in his filed return as the correct statutory tax. It also forces the taxpayer either to pay the deficiency determined by respondent or to engage in a lengthy and costly[25] litigation in the Tax Court and there affirmatively show wherein such determination is erroneous. Under the opinion below, respondent may mail notices of deficiency with as little regard for the merits of his determination as a district attorney issuing request subpoenas. Whether he adheres to his statutory power and determines "the correct amount of the tax" (*IRC* 57) in accordance with the statutory provisions which state in detail how such correct amount shall be determined or whether, in a last minute rush to beat the

25. Petitioners have already expended in printing costs and court fees alone more than the deficiencies here involved. Since such costs and fees are not recoverable from respondent, they would advise their clients—as other lawyers advise theirs—against litigating respondent's determinations, no matter how arbitrary and excessive they may be. In the vernacular, respondent's agents are engaged in quite a racket. See 117 *N. Y. World-Telegram and Sun* #155, p. 1 (March 4, 1950).

dead line of the limitation period, he flouts the statute and mails a determination which shows on its face that it is not and *cannot be* "the correct amount of the tax", is immaterial according to the opinion below. No matter how obviously arbitrary and in excess of his statutory powers his determination may be, the statute of limitation is tolled thereby and the taxpayer must pay the determined deficiency or litigate in the Tax Court, says the instant court of appeals.

These are not the first cases in which respondent has made such obviously arbitrary determinations and so flagrantly exceeded his statutory powers. Only respondent knows how many of these he has mailed[8] and later compromised with timorous taxpayers. Only the Tax Court knows how many times it has completely ignored in its published opinions—as it did here—the taxpayer's claim that the notice of deficiency was invalid because obviously arbitrary and obviously in excess of respondent's statutory powers; how many times there has been no appeal from such opinions because the printing and appeal costs equalled or exceeded—as they do here—the taxes in dispute. Unless the opinion below is reviewed by this Court and reversed, it will surely be accepted by respondent as judicial approval of his wholesale issuance of notices of deficiency similar to the instant ones.[26]

Contrary to decisions of this Court and of other circuit courts and to the provisions of the Administrative Procedure Act, the court below has held that the Tax Court is not restricted to the issues raised by the notice of deficiency as limited by the petition and answer, that

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26. The instant notices of deficiency were issued 6¼ years after the Attorney General's Committee had expressed chagrin at the mailing of such notices (*supra* footnotes 3, 9) and several months after the Attorney General had warned respondent that APA 5(a) was "mandatory." *Atty. Gen.'s Manual on APA*, 47 (1947). And yet, in his November 1949 brief to the court below, respondent said that the issuance of notices of deficiency such as the instant ones "is invariable practice."

respondent may there indulge in fishing expeditions;[27] and that if the taxpayer does not guess what issues respondent is trying to inject into the trial and is not prepared to meet them with affirmative proof at the trial, "she has no one to blame but herself". Such procedure in a court of record has frequently been condemned by this Court as a denial of due process of law and a violation of the Constitution.

Contrary to decisions of other circuit courts, the court below has held that even after the taxpayer shows that respondent's stated reason for disallowing a claimed deduction is erroneous, the taxpayer still has the burden of proving at the trial that such deduction falls within the statutory provisions allowing it and that it does not fall within the statutory provisions disallowing it.

Wherefore, it is respectfully prayed that a writ of certiorari issue to the United States Court of Appeals for the First Circuit.

New York, New York, April 6, 1950.

Respectfully submitted,

EMILY MARX,
Attorney for Petitioners.

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27. See Appendix to the annexed brief for a flagrant violation by the Tax Court of *APA* 6(c), *RTC* 44 and the decisions of this Court forbidding the use of exploratory subpoenas.

Supreme Court of the United States

OCTOBER TERM, 1949.

No. .....

EMILY MARX, *et al., Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE.

PETTIONERS' BRIEF.

I.

The Administrative Procedure Act and the decisions of this Court required the court below to set aside the notices of deficiency and hold them to be nullities.

The court below apparently conceded that the instant notices of deficiency were obviously arbitrary on their face and invalid (130). There can be little question of their arbitrariness. Clearly no law office can operate without paying office rent, stenographers' salaries, telephone charges, electricity, postage, stationery, filing fees, printing, library charges (42). Even where a taxpayer

has no proof whatever of the specific amounts he spent for each of such items, he is entitled to a reasonable allowance for such expenditures. *Cohan* v. *Com.*, 39 F2d 540, 543-4 (2 Cir. 1930). This the respondent well knew and therefore tried to make it appear from his notices of deficiency that petitioners had not itemized their expenses in their returns (7).

But these notices were more than obviously arbitrary. On their face they clearly showed that respondent had no statutory power to issue them. Nowhere does IRC give him the power to assess a tax on "total receipts" or to disallow all business expenses and all business depreciation because of "the absence of adequate and complete records" (7). The records that petitioners kept were for twenty years deemed by respondent sufficient for income tax purposes (4). IRC gives him the power *prospectively* to require further records to be kept, but still no power to tax "total receipts" when his agents suddenly get a notion that five years previously a taxpayer should have kept "permanent books of account" and not relied on cancelled checks as proof of expenses paid therewith (4). Respondent's statutory power is limited to a determination of "the correct amount of the tax" (*IRC* 57), to a determination of the "deficiency" or difference between such "correct amount of the tax" and the tax computed by the taxpayer in his return. *IRC* 271(a). The statute tells respondent in detail how the "correct amount of the tax" is to be computed; such computation cannot be made by levying on "total receipts" the tax which the statute directs shall be levied only on "net income" (*IRC* 11, 12), which is twice removed from "total receipts".

That respondent is an administrative agency cannot well be questioned. His deficiency determination is an adjudication which he himself admits he cannot make without giving the taxpayer an opportunity for a hearing. 11 *Fed. Reg.* 177A-38, 42-3. His regulations, requiring

that such hearing opportunity be given,[28] are just as much a part of the Internal Revenue Code as if they were actually set out therein in full instead of merely being incorporated therein by reference. *Federal Crop Ins. Corp.* v. *Merrill,* 332 U.S. 380, 385 (1947). He is therefore required by *APA* 5(a) to advise the taxpayer of all his objections to the filed return before he concludes his hearings and makes his final deficiency determination. If he withholds from the taxpayer any of his reasons for altering the filed return, while at the same time requiring the taxpayer to give him in detail the facts and legal grounds establishing respondent's stated objections to be without merit, he is engaging in poker game tactics which *APA* 5 forbids. And his deficiency determination, when made after a hearing on the taxpayer's written protest, must conform with *APA* 6(d) and clearly state the grounds for his determination. He may not equivocate and state catch-all grounds to be particularized in his counsel's brief to the tax court after he has studied the transcript of testimony and noted possible loopholes left by the taxpayer.[29]

The instant notices of deficiency were therefore "arbitrary, in excess of statutory authority, not in accord-

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28. Due process of law would require such hearings if respondent did not grant them voluntarily. *U.S. v. Illinois Central R. Co.,* 291 U.S. 457, 463 (1934); *Opp Cotton Mills v. Administrator,* 312 U.S. 126, 152-3 (1941); *Jordan v. Am. Eagle Fire Ins. Co.,* 169 F2d 281, 287 (CADC 1948). The tax court trial is not a "trial de novo in any *court*" (Point II *infra*) nor is it a "trial de novo" of the issues that were before respondent. His function is to ascertain whether there is any difference between the tax imposed by IRC and the tax as self-assessed by the taxpayer. Such "function of investigation and finding has not been conferred upon" the Tax Court and therefore it may not proceed de novo. *Kessler v. Strecker,* 307 U.S. 22,35 (1939). Its function is to determine whether respondent has committed reversible error and differs only from judicial review in that it may receive factual testimony in addition to legal argument to support the claimed error. A "trial de novo" within the meaning of APA 5 would require the elimination of the present presumption that respondent's determination is correct *plus* a Congressional enactment making the tax court a "court."

29. See Sen. Doc. #10, *supra* footnote 3, p. 73, notes 242, 243. Because respondent's deficiency determinations usually do not inform even the reviewing Tax Court of the grounds therefor, that tribunal does not "review" his determinations but instead examines the filed returns as if *IRC* 57 were directed to it. Therefore, it frequently disregards the notice of deficiency and steps outside the issues made by the pleadings before it. See Point II *infra.*

ance with law", within the meaning of *APA* 10(e)(B). Under that statute, the Court of Appeals had no alternative but to hold respondent's notices of deficiency unlawful and to set aside the determinations made by respondent thereby.

Now here follows the argument that the court below thought "ingenious" (131). Respondent's determinations differ from those of other administrative agencies in that there is a statute of limitations running against him, which no court has the power to ignore. *Cf. Kavanagh* v. *Noble,* 332 U.S. 535, 539 (1947); *Helvering* v. *Newport Co.,* 291 U.S. 485, 490 n.2 (1934). Therefore, when respondent's invalid determinations are set aside—as directed by *APA* 10(e)—and the statutory limitation period against him has expired, he cannot again question the correctness of the filed income tax return. *IRC* 275(a). To permit him to amend[30] his deficiency determination to claim a deficiency under an entirely different section of the Internal Revenue Code, on an entirely different basis of liability, calling for entirely different facts from the taxpayer,[31] would be a violation of *IRC* 275(a). *Union Pacific Ry.* v. *Wyler,* 158 U.S. 285, 297-8 (1895); *Harriss* v. *Tams,* 258 N.Y. 229, 243 (1932). When challenged by a notice of deficiency which respondent had no statutory power to issue and which *APA* requires the courts to hold unlawful and set aside, the tax shown in the taxpayer's filed return remains the correct statutory tax, as if no notice of deficiency had been mailed by respondent within the statutory limitation period. *Virginian Hotel Co.* v. *Helvering,* 319 U.S. 523, 527 (1943). Besides, if respondent is permitted to amend such unlawful and arbitrary

30. There was no attempt by respondent to amend his notices of deficiency or his answers in the instant actions. But the opinion below seems to amend them for him.

31. We have found no case which permitted such an amendment. In *Davison v. Com.,* 60 F2d 50,51 (2 Cir. 1932), the court specifically pointed out that there was no change of issues, that the amendment there sought by respondent increased the amount of the deficiency on the same item originally objected to and on the same expressly stated theory.

notices of deficiency, he will certainly continue to issue them and thus defeat the purpose of Congress in directing that they be set aside, i.e. to stop respondent from issuing them and so abusing taxpayers.[32]

Even if APA had not been enacted, the decisions of this Court required the court below to set aside the notices of deficiency and hold them to be *nullities*. Because they were obviously arbitrary: *ICC* v. *Louisville & N. RR.*, 227 U.S. 88, 91 (1913); *Sante Fe Pac. RR.* v. *Fall*, 259 U.S. 197, 199 (1922); *Donaldson* v. *Read Magazine, Inc.*, 333 U.S. 178, 182, 196 (1948); *Chicago Junction Case*, 264 U.S. 258, 265 (1924). Because they were in excess of his statutory powers: *Hannegan* v. *Esquire, Inc.*, 327 U.S. 146, 158 (1946); *Gegiow* v. *Uhl*, 239 U.S. 3, 9 (1915). To the same effect are *U.S.* v. *Doherty*, 27 Fed. 730, 732, 735 (SDNY 1886); *Hines* v. *Welch*, 23 F2d 979, 982 (CADC 1928); *General B. System, Inc.* v. *Bridgeport B. Station, Inc.*, 53 F2d 664, 668 (DC Conn. 1931). Because of their failure to state the grounds of the determinations: *Beaumont, S.L. & W. Ry.* v. *U.S.*, 282 U.S. 74, 86 (1930).[33]

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32. Sen. Doc. #10, *supra* footnote 3, emphatically drew to the attention of Congress the prevalence of such arbitrary notices of deficiency against which the individual taxpayer stands helpless. APA 10(e)(B) was intended by Congress as a codification (Sen. Doc. #248, *supra* footnote 23, at p. 39) of decisions of this Court setting aside and holding *void* not only administrative determinations made in excess of statutory authority but also those in which such authority had been exercised "arbitrarily and unjustly" or capriciously or in violation of due process or in such "unreasonable manner as to cause it, in truth, to be within the elementary rule that the substance, and not the shadow, determines the validity of the exercise of the power." *ICC v. Illinois Cent. RR*, 215 U.S. 452,470 (1910); *ICC v. Union Pacific*, 222 U.S. 541,547 (1912); *NY & Queens Gas Co. v. McCall*, 245 U.S. 345,348 (1917); *Kessler v. Strecker*, *supra* footnote 28, at p. 34.

33. A pertinent opinion appears in *Matter of Scudder v. O'Connell*, 272 App. Div. 251, 253-4 (N.Y. 1st Dept., 1947), involving the review of a determination of the N. Y. State Liquor Authority:

"Findings of fact serve other purposes besides affording a basis for intelligent judicial review. The obligation to formulate findings, rather than simply to announce a result, tends to assure considered action by the administrative deciding officer. As a corollary, the findings themselves offer some assurance to the parties that the decision has been arrived at rationally, on the evidence; and the findings at least enable the parties to judge for themselves the soundness of the decision, and afford them assistance in deciding whether or not to seek to reverse it on rehearing or judicial review."

The court below has held in effect that respondent—alone of all administrative agencies in this country—may make determinations which are obviously arbitrary on their face, obviously in excess of his statutory powers, obviously taxing an item that he is daily telling taxpayers he has no statutory power to tax.[34]

Helvering v. *Taylor*, 293 U.S. 507, 514 (1935), upon which the court below relied, did not so hold. It was not concerned with a notice of deficiency patently in excess of respondent's statutory powers. It was *not* concerned[35] with the legal effect of an obviously arbitrary notice of deficiency except to say, by way of dictum: "The fact that the commissioner's determination of a deficiency was arbitrarily made may reasonably be deemed sufficient to require the board to set it aside." Three Tax Court decisions there cited with approval did just that; they set aside the notices of deficiency that were obviously arbitrary on their face and *entered decrees of no deficiency.*

An extensive search of reported judicial decisions has failed to reveal any opinion in which a distinction is made between "invalid" and "void"; nor have we found any authority on semantics[36] to support the holding of the court below that "invalid" does not mean "void" (132).

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34. "The law taxes a business or profession on its profits—not its total receipts. Therefore, Form 1040 provides Schedule C [formerly Schedule D (42) or H (43)] on page 2 of the form to help you subtract your costs from your receipts." Bureau of Internal Revenue, *How to Prepare Your U.S. Income Tax Return* (1949) p. 9.

35. This Court there (at p. 511) expressly limited itself to the question raised by the petition for writ of certiorari, i.e. whether the court of appeals erred in remanding to the tax court for a new hearing on the only question at issue between the taxpayer and respondent—the cost basis of preferred stock which the taxpayer had sold out of a block of preferred and common. Respondent had argued to this Court that his determination—sustained by the tax court—should have been affirmed by the court of appeals because the taxpayer failed to prove the cost of such preferred stock (although he had shown that respondent's determined cost was erroneous).

36. "Invalid" means "having no force or effect; void; null." Webster, *New International Dictionary* 1304 (1945, 2nd ed. unabr.). *Roget's Thesaurus* (1933) defines "invalid" as "impotent, powerless" (#158); "unlawful, unconstitutional, illegal" (#925). This Court has consistently used "invalid" as a synonym of "void." *Atlantic Coast Line v. Florida*, 295 U.S. 301, 329 (1935); *Donaldson v. Read Magazine, Inc., supra; Yakus v. U. S.*, 321 U. S. 414, 447 (1944); *Joseph v. Carter & Weekes Co.*, 330 U.S. 422, 433, 443 (1946).

In any event the decision below, which establishes respondent as the only administrative agency in the United States whose obviously arbitrary and invalid determinations have the same legal effect upon our citizens as valid ones, as the only official who may with impunity make determinations obviously in excess of his statutory powers, as an administrative agency whose known abusive acts the Administrative Procedure Act did not touch, should be reviewed by this Court.

II.

The Administrative Procedure Act, the due process clause of the Constitution and the decisions of this Court and other Circuit Courts required the court below to set aside the Tax Court decisions and hold them to be unlawful.

The Tax Court is not a "court" but merely an administrative board, with quasi-judicial duties. *Old Colony Trust Co.* v. *Com.*, 279 U.S. 716, 725 (1929); *Helvering* v. *Rankin*, 295 U.S. 123, 131 (1935); *Goldsmith* v. *BTA*, 270 U.S. 117, 121 (1926). Its powers are circumscribed by the Internal Revenue Code. *Com.* v. *Gooch Milling & Elevator Co.*, 320 U.S. 418, 422 (1943). It "has merely a revisory capacity and its jurisdiction is limited to the issues raised by the pleadings before it." *Hanby* v. *Com.*, 67 F2d 125, 127 (4 Cir. 1933); *General Utilities Co.* v. *Helvering*, 296 U.S. 200, 206 (1935). With full knowledge that the Tax Court had been held to be an administrative agency within the meaning of APA [*Lincoln Electric Co.* v. *Com.*, 162 F2d 379, 382 (6 Cir. 1947)] and that without special legislation "it is subject to the requirements of the Administrative Procedure Act and its procedure must be in conformity with that law" [93 *Cong. Rec.* 8390

(1947)], Congress recently refused[37] to place the Tax Court "under the judiciary". 94 *Cong. Rec.* 7927 (1948). It is clear, therefore, that its adjudications, hearings and decisions must comply with the requirements of APA, that its statutory authority is limited by APA.

Basic among APA requirements is that the taxpayer must be "timely informed of the matters of fact and law asserted" by respondent as the grounds of his determination; that respondent's answer to the petition must be a "responsive pleading" and not just a printed form applicable to all Tax Court petitions; that the Tax Court must state findings and conclusions upon "all the material issues of fact and law presented on the record" and must confine its findings and conclusions to issues of which the taxpayer has been timely informed. *APA* 5(a), 8(b). The instant petitions clearly stated, as to respondent's determinations[38] that "total receipts" were taxable as if they were net income (6-7),

(1) That this was a violation of *IRC* 11, 12; (2) that the claimed expenses and depreciation had been substantiated to respondent's agents with cancelled checks and tabulations thereof; (3) that his agents had claimed that permanent books of account were required as substantiation and that cancelled checks and tabulations thereof were

37. The Judiciary Code (HR 3214) originally contained seven sections dealing with the Tax Court, starting with the statement that it "was a court of record." The debates centered around the *Lincoln Electric* holding and the question of whether the Tax Court should be made a Court of Record so that it would no longer be subject to the Administrative Procedure Act. It was pointed out that in his reports to Congress prior to the passage of APA, the Attorney General had expressed the opinion that "courts" in APA 1(a) included the Tax Court, and that *Lincoln Electric* had now overruled his interpretation. Although Congress was warned that legislation must be passed if it was its desire to change the status of the Tax Court from an administrative board to a court, the same Senate Judiciary Committee which had put APA into its final shape, eliminated all reference to the Tax Court from the Judiciary Code as finally passed. Sen. Rep. #1559, 80th Cong. 2nd sess. (1948).

38. If certiorari is granted, petitioners will show in their brief to this Court that the other determinations in the notices of deficiency and the decisions below thereon, were similarly unlawful.

insufficient (3, 4). Complete schedules of such cancelled checks were annexed to the petitions (8-10, 21-5). If petitioners misinterpreted respondent's notice of deficiency—if the grounds for his disallowance of the business expenses and depreciation were not that permanent books of account were required and that cancelled checks were insufficient proof that such expenditures had in fact been made—the time for respondent to tell petitioners what his grounds for disallowance were was when he filed his answers.[39] Because the Tax Court consistently refused to enforce its rule 14 against respondent and constantly exposed taxpayers to a switching of "issues" after respondent's brief told that court what the "issues" were, and frequently failed to make findings on the issues that *were* raised by the pleadings, Congress enacted *APA* 5, 7 and 8. Now a tax court decision based on "issues" of which the taxpayer was not timely informed, raised neither in the notice of deficiency, the petition nor the answer, and ignoring the issues which were raised by those three pleadings, is "agency action not in accordance with law, in excess of statutory limitations, short of statutory right and without observance of procedure required by law". *APA* 10(e). Therefore, the court below was required by *APA* 10(e) to set aside the instant decisions of the Tax Court.

To hold as did the Tax Court that the issue of deductibility is always present in all tax court proceedings (37) or, as did the court below that petitioner "has no one to blame but herself" if she "did not in fact understand" that statutory deductibility was in issue (130), is to make a mockery of the Administrative Procedure Act.

39. Had respondent told petitioners at the two hearings that preceded the issuance of his notices of deficiency that he was contesting statutory deductibility, but was satisfied with their proof that the claimed expenditures had in fact been made, there probably would have been a settlement and neither a notice of deficiency nor a tax court trial. But the absence of permanent books of account could not so be disposed of; petitioners could not produce from a prestidigitator's hat in the year 1946 or 1947, permanent books of account for the years 1940 and 1941. *Cf.* supra footnote 33.

Had respondent's answers singled out some of the items in the exhibits attached to the petitions and admitted that those were "properly deductible", perhaps petitioners could be accused of myopia in failing to detect that deductibility was at issue. But surely when the petitions set out in plain language petitioners' understanding that only the question of permanent books of account versus cancelled checks and tabulations was at issue and the answers were merely pro forma denials, no such accusation can rightfully be made.[40] Respondent thoroughly cross-examined petitioner on her records of receipts and disbursements but abandoned that issue when the trial judge indicated that he thought the records kept by petitioner were adequate (TR 40, p. 246-50).

Even before the enactment of the Administrative Procedure Act, this Court condemned administrative hearings at which the issues were not clearly defined and held that the petitioner before an administrative tribunal, no less than a litigant before a court, is "entitled to know the basis of the complaint against it, and to explain its conduct, in an effort to meet that complaint". *NLRB* v. *Mackay Co.*, 304 U.S. 333, 350 (1938). "The right to a hearing", this Court said in *Morgan* v. *U.S.*, 304 U.S. 1, 18-9, 22 (1938), "embraces not only the right to present evidence but also a reasonable opportunity to know the claims of the opposing party and to meet them"; and held "fatally defective" and "invalid" administrative orders

40. Books of account and the entries therein have *no relevancy whatever* on statutory deductibility. They "neither justify an allowance nor a disallowance of the deduction provided for in the statute." 4 Mertens, *Fed. Income Taxation* 326 (1942); *Helvering v. Midland Ins. Co.*, 300 U.S. 216, 223 (1937). In *McGinn v. Com.*, CCH Dec. 12, 810(C) (1942), the Tax Court had held that checks and check stubs were sufficient substantiation of expenses claimed as deductions. The word "substantiate" means "to establish the existence or truth of, by true or competent evidence." *Graves v. School Com. of Wellesley*, 299 Mass. 80, 86 (1937); *People v. Hall*, 140 Calif. App. 745, 753 (1934); Funk & Wagnalls, *New Standard Dictionary* 2412 (1949); *Webster, op. cit.* 2514. Respondent adopts this meaning of the word in his Regulations. Reg. 111, Sec. 29.23(a)-2.

made after a hearing at which no such opportunity is given to "those who are brought into contest with the Government in a quasi-judicial proceeding". In *General Utilities Co.* v. *Helvering, supra,* this Court said: "*Always* a taxpayer is entitled to know with fair certainty the basis of the claim against him", and held that the Tax Court had *no power* to consider grounds of deficiency determination dehors the pleadings. To the same effect is *Helvering* v. *Savage,* 297 U.S. 106, 109 (1936); *Helvering* v. *Tex-Penn Co.*[9] In *Helvering* v. *Cement Investors, Inc.,* 316 U.S. 527, 535 (1942) and *Helvering* v. *Wood,* 309 U.S. 344, 349 (1940), this Court refused to permit respondent to urge before it in support of his deficiency determination "questions not fairly within the issues as framed by the Commissioner" or to shift to ground which the taxpayer "had every reason to think was abandoned in the earlier stages of this litigation." *Helvering* v. *Gowran,* 302 U.S. 238, 245 (1937), upon which respondent relied below to support the Tax Court's shifting of issues, involved undisputed facts and the submission to the Tax Court of questions of law only. Its result was "harsh" on the taxpayer. *Anderson* v. *Com.,* 156 F2d 591, 593 (2 Cir. 1946). If it is construed to support the instant Tax Court decisions, it has been overruled by *APA* 5(a).

The Courts of Appeals have likewise held that where the issues raised by the notice of deficiency, the petition and the answer are decided by the Tax Court or conceded by respondent in the taxpayer's favor, or are abandoned by respondent, the Tax Court has "nothing left for it to do, other than to enter judgment in favor of the petitioners." *Popular Price Tailoring Co.* v. *Com.,* 33 F2d 464, 465 (7 Cir. 1929); *Blair* v. *Mathews,* 29 F2d 892, 893-4 (5 Cir. 1928); *Lenox Clothes Shops, Inc.* v. *Com.,* 139 F2d 56, 60 (6 Cir. 1943); *cf. Harvey* v. *Com.,* 171 F2d 952, 955 (9 Cir. 1949); *Hanby* v. *Com., supra.* "In tax cases, the burden of proof *is measured by the deficiency letter.* What-

ever grounds are stated by the Commissioner as the base for the additional taxes must be overthrown by the taxpayer and the oral testimony must remain in the niche in which it is placed by the pleadings, admissions and concessions of counsel for the respective parties which amplify or restrict it." *Lenox Clothes Shop, Inc., supra.* The Tax Court's function is "primarily judicial and not inquisitorial" and its findings of fact and conclusions of law on matters dehors the pleadings and not required by pending issues, are merely "gratuitous". *O'Rear* v. *Com.*, 80 F2d 473, 475 (6 Cir. 1935). Issues not raised in the pleadings are "not properly before the Board". *Com.* v. *Sussman,* 102 F2d 919, 922 (2 Cir. 1939); *State Cons. Oil Co.* v. *Com.*, 66 F2d 648, 650 (9 Cir. 1933).

The decision of the instant Court of Appeals seems to be the first in which it was held that the Tax Court is not limited to the issues raised by the pleadings, *including the notice of deficiency.*[41] In affirmatively approving, as it does, the Tax Court's stated theory of its function to examine the filed return and discover whether anything is wrong with it,[42] the court below has decided a fundamental question in income tax law contrary to the opinions of this Court and the above decisions of other circuit courts.

The remand cases[43] to which the court below referred,

41. *Cf. BTA v. U.S.*, 37 F2d 442, 444 (CADC 1929), holding that the issues between the taxpayer and respondent are made by the notice of deficiency and the petition to the tax court, whether or not respondent filed an answer.

42. *Supra,* p. 7-8. The Tax Court always limits *the taxpayer* to the issues raised in his petition. *Second Carey Trust v. Helvering,* 126 F2d 526, 529 (CADC 1942); *Steele-Wedeles Co. v. Com.*, 63 F2d 541, 543 (7 Cir. 1933).

43. *Laird v. Com.*, 85 F2d 598, 601 (3 Cir. 1935); *Durkee v. Com.*, 162 F2d 184, 187 (6 Cir. 1947). To the same effect are: *Forbes v. Hassett,* 124 F2d 925, 928 (1 Cir. 1942); *Helvering v. Taylor, supra; Stock Yards Nat. Bk. v. Com.*, 153 F2d 708, 712 (8 Cir. 1946); *Worcester Co. Trust Co. v .Com.*, 134 F2d 578, 580 (1 Cir. 1943); *Industrial Trust Co. v. Com.*, 165 F2d 142, 148 (1 Cir. 1947); *Andrews v. Com.*, 135 F2d 314, 318 (2 Cir. 1943); *Hague v. Com.*, 132 F2d 775, 778 (2 Cir. 1943); *Federal Nat. Bk. of Shawnee v. Com.*—F2d—(10 Cir. 2/13/50); *Fairmount Cemetery Assn. v. Helvering,* 79 F2d 163, 165 (CADC 1935).

remanded for a further hearing *on the issues raised by the pleadings.* In none of them was there any question but that the matter in dispute *was* the issue raised by the pleadings. In *General Utilities Co.* v. *Helvering, supra,* this Court refused to remand where the point in dispute before it was not one of the issues raised in the notice of deficiency, the petition or the answer.

To read into the pleadings an issue not stated therein, as did the opinions below, is an obvious violation of due process. "The judicial process is required to exhibit a fair effort at finding truth and exercising wisdom. Without that effort—involving notice, hearing, and deliberation—it loses its rank as process; it becomes gross will." Cahn, *The Sense of Injustice* 19 (1950). "The law on the subject is clear. Pleadings and a distinct issue are essential to every system of jurisprudence, and there can be no orderly administration of justice without them." *Lamphere* v. *Lang,* 213 N.Y. 585, 588 (1915). If a lesser justice may now lawfully be dispensed in the Tax Court, as the instant opinion below has held, it should be done only after a review by this Court. To that the taxpayers and the Congress are surely entitled.

Respectfully submitted,

EMILY MARX,
Attorney for Petitioners.

Appendix.
(see footnote 4)

In the income tax return form prescribed by respondent,[44] rents received and rents paid out on property are required to be shown in Schedule B, with a computation showing either net profit or net loss (44). The total of this schedule is then required to be included in *gross income,* under item 5 of gross income items (44). However under *IRC* 22(a) *all* rents *received* are *gross income. Hort* v. *Com.,* 313 U.S. 28, 30-1 (1941); *N.A. Oil Cons.* v. *Burnet,* 286 U.S. 417, 424 (1932). And under *IRC* 23(a) there may be deducted from gross income in computing taxable net income, rents paid out "for the continued use or possession, for the purposes of the trade or business, of property to which the taxpayer has not taken title or in which he has no equity". *IRC* 23(a)(1)(A). Schedule B, of course, does not alter the income status of rents received or the income status of rents expended. The resulting "net profit" or "net loss" for which that schedule provides has *no statutory* recognition. It is merely an administrative device for tabulating such income items. A leasehold acquired for business purposes is property to be scheduled in Schedule B. *Reg.* 111, sec. 29. 23(a)-10. The amount paid therefore is rent (*Hort* v. *Com., supra*) which, even if paid in one lump sum, may be allocated over the term of the lease with one aliquot part deductible annually under *IRC* 23(a)(1)(A).

The 1941 return of petitioner VH showed in such Schedule B rents received from a leasehold and rent paid out by him to the lessor for the possession of the leased realty (44). The resulting loss ($3975) was entered as item 5 of his gross income (44). Respondent's notice of deficiency—sent out with the 1940 notice and under the same

44. 11 *Fed. Reg.* 177A-41 (1946). Schedule and item lettering and numbering are here given as they appeared in the return forms prescribed for the year 1941. The same schedules and items appear annually in the return forms but are differently lettered and numbered each year.

rush to toll the statutory limitation period which had been thrice extended—"adjusted" this item 5 of gross income by adding such $3975 to VH's taxable net income (19, 18) because "net rental loss • • • held not to represent an allowable deduction from your gross income under any of the provisions of section 23 of the Internal Revenue Code" (19). Respondent neither taxed the reported rental income received by VH nor allowed as a deduction any part of the reported rent paid out by him.

This deficiency determination was obviously in excess of respondent's statutory powers and obviously arbitrary. Respondent had no power to eliminate from gross income the rentals received by VH.[45] His characterization of item 5 as a claimed "deduction from your gross income" was obviously unrelated to the filed return.[46] Respondent might have disallowed all or part of the rent claimed as an expense in Schedule B(44), *if* he had a statutory reason under *IRC* 23(a) for such disallowance; but such an "adjustment" would have necessitated a deficiency determination showing on its face that the rents received remained included in VH's gross income as required by IRC 22(a). His stated reason for his determination—that a "net rental loss" is not "an allowable deduction from gross income under any of the provisions of IRC 23" (19)—merely states what is the fact, i.e. that IRC makes no provision for "net rental loss"[47] but that this is the way re-

45. Under the determination below, what happens when the leasehold shows a profit? If rents received are not gross income and rent paid for the leasehold is not a business expense under IRC 23(a)(1)(A), how are these items to be treated when receipts exceed expenses, as they did in the year 1949?

46. The deduction from gross income was $5000, which fact even a cursory inspection of the filed return would have disclosed (44).

47. A "loss" under *IRC* refers exclusively to a *capital* loss, as that term is used in accepted accounting procedure. Rentals are income receipts and income expenses and before the difference between them can become an IRC "loss," i.e. a capital loss, the income account must be closed for the year and such difference then credited or debited to the taxpayer's capital account. Income receipts and income expenses cannot result in an IRC "loss" or "gain" during the year of receipt or expenditure. Only when such items lose their "income" character and under accepted accounting procedure become "capital," can an IRC "loss" occur.

spondent requires taxpayers to schedule their IRC 22(a) rental income and their IRC 23(a) rental expenses in his prescribed return forms. Prior to the issuance of such notice of deficiency, respondent had twice examined the facts involved in this leasehold and had twice determined (16, 49-50, 62, 63), in writing, that the leasehold was entered into and was being operated for business purposes, that the rent reserved in the written lease was reasonable, that the rents received from the property were reportable as gross income under *IRC* 22(a) and the rent payable under the lease was deductible from such gross income under *IRC* 23(a)(1)(A). And simultaneously with the issuance of such notice of deficiency, respondent had taxed to the lessor corporation as rent received by it, the same rental payment[48] that he now claimed was not deductible by this petitioner, the lessee (52).

The petition to the Tax Court claimed that such disallowance was erroneous (13) and that during the term of the leasehold under which VH had paid out and received in the rents reported in his return—and in fact *during the very year which the notice of deficiency concerned*—respondent's agent had personally examined the leased property, conferred with the subtenants and determined that the difference between rents received in and the rent and other expenses paid out by VH was an allowable deduction for the year 1939 (16-7, 63-4). A copy of the agent's report [49] was set out in the petition with the statement that the same facts applied to the year 1941 except for the difference in amounts paid out and amounts received in (17).

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48. After a complete examination of the records and tax returns of the lessor corporation (73) from the date of its incorporation thru 1946 and the issuance of a 30-day letter which sought to charge the corporation with more rental income than it had in fact received and reported (TR 395, aff. M). Such 30-day letter was withdrawn by respondent as an "error" simultaneously with his issuance of the instant notices of deficiency.

49. Which the Tax Court refused to receive in evidence (62, 64), although it permitted respondent to cross-examine this petitioner on the income tax return which that report had affirmatively approved (106).

At the opening of the Tax Court trial, the issue on this "adjustment" was stated by counsel as follows:

By petitioners (54): "The taxpayer, Victor House, has since 1935 had a business lease on certain real estate in Alstead, New Hampshire. On that he has reported receipts and rent as a deduction and he has shown his rental receipts, his business receipts. In 1941 the property was examined by the Internal Revenue Agent in Portsmouth. The agent went around to the property, examined the tenants, and everything else; and made a report, approved by the agent in Portsmouth, stating the rent was a reasonable rent and approving the deduction in the year 1939—a deduction for loss on that rent".

By respondent (55): "There is some real estate up in New Hampshire. It will be necessary to understand the status of that New Hampshire real estate. It does turn up that the title is in the name of a corporation owned, incidentally, by these petitioners. Then we find that the corporation purports to enter into a lease of certain buildings to Mr. House and then Mr. House subleases some of the buildings for a lesser figure and deducts a loss, the filed returns showing it always has a loss".

By petitioners (56): "It is not true that the stock of The Houses, Inc. is owned by the petitioners".

Petitioner VH testified that he paid the corporate owner of the realty the rent reserved n the written lease (61)—which was received in evidence (61),[50] that he entered into

50. The lease, dated November 12, 1935, required the lessor to "forthwith make all necessary repairs to the demised premises to put them into rentable condition before the summer of 1936," to keep the property insured, pay all taxes, etc. (TR 308, Ex. 2). Respondent announced in the middle of the trial that he was trying to ascertain "the source of the money that was used in acquiring and renovating this property at Alstead" (TR 40, p. 111); but he objected to all testimony on "the details of the negotiations that led up to the purchase of that property" (TR 40, p. 257). The lessor would have demolished the four houses on the demised premises—which were uninhabitable when the property was acquired by it (TR 40, p. 76, 159-62, 187-9)—but for VH's lease (62, 66; TR 40, p. 163). The reserved rent was determined by impartial experienced realtors of the vicinity (61, 66; TR 40, p. 144). Over respondent's objection (TR 40, p. 162), VH was permitted to show that he had operated the leasehold as a business and was still so operating it (TR 40, p. 188-9; 261-2, 256; TR 308, Ex. 4).

that lease to make a profit from the subletting of the property (63, 66) and that he did not have title to the leased property or an equity in it (35). On cross-examination, the Tax Court permitted respondent to go on a fishing expedition for 44 pages of the Transcript of Testimony (TR 40, pp. 102-44, 250-2) into the origins of the lessor corporation; its acquisition of the leased property; the sources from which the lessor obtained the funds to purchase the property; the sources from which such sources obtained such funds; the origins and operation of a corporation which had been dissolved more than ten years previously, in which this petitioner had had an interest, which had been organized some twenty years previously and been operated by a deceased relative; the interior, exterior and furnishings of this petitioner's residence adjoining the leased property; the financial resources of this petitioner's children and the sources from which such financial resources came, etc. (88-106). Of course, this petitioner was not prepared to meet such extraneous issues (50). Even the Tax Court did not know what respondent was driving at (40). Then, in his brief to the Tax Court, respondent for the first time announced that his determination had been made under *IRC* 23(e) and 24(b).[51] He quoted to that court judicial decisions[52] holding that inter-family *sales* resulting in a shifting of taxable income are subject to judicial scrutiny as to their bona fideness and that losses resulting therefrom are specifically declared to be non-deductible by *IRC* 24(b)(1), and concluded: "A clearer

51. Sec. 23(e) allows as deductions in computing net income losses incurred in trade or business; or in any transaction entered into for profit though not connected with the trade or business; or of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty. *Reg.* 111, sec. 29.23(e)-1 shows clearly that this section applies only to *capital* losses. Sec. 24(b) disallows losses from sales or exchanges of property between members of a family, family corporations. *Reg.* 111, sec. 29.24-6 confirms that this section applies only to *sales or exchanges* of property between certain classes of persons.

52. *Com. v. Sunnen*, 333 U. S. 586 (148); *McWilliams v. Com.*, 331 U. S. 694, 699 (1947).

case of intra-family transaction could not be found than the matter of this so-called lease between the corporation of which he was president and in which the sole beneficial interest was in his children". The Tax Court sustained respondent's deficiency determination because of (40) "the absence of a satisfactory showing in the record that the payments to the corporation constituted in reality, rentals" (40).[53] To the Court of Appeals respondent argued in his brief: "The claimed loss was not real in the sense of being incurred in a transaction entered into for profit. Loss transactions between family members and family corporations are naturally subject to special scrutiny (citing *Com.* v. *Sumner*[52]). Taxpayer cannot sustain the burden of proving that the loss resulted 'from a transaction entered into for profit' or that it was an 'unintentional parting with something of value' (quoting from *Dresser* v. *U.S.*[54]). In effect Mr. House, instead of simply donating his funds to The Houses, Inc. for the benefit of his children, voluntarily entered into an unfavorable leasing arrangement, thereby creating an artificial loss." The Court of Appeals affirmed without special comment (132).

Thus what started with an annual expense incurred by this petitioner in the operation of his leasehold and deductible if it can "conveniently come within *IRC* 23(a)(1)(A)",[55] ends up in respondent's briefs as a loss "from the sale of property, its destruction or physical injury" under *IRC* 23(e),[56] which section applies only to losses of capital assets and only when such losses are "fixed by a

53. "The term 'rentals' [as used in IRC 23(a)(1)(A)] must be taken in its usual and ordinary sense, that is, as implying a fixed sum to be paid at stated times for the use of property." *Duffy v. Cent. R.R.*, 268 U. S. 55,63 (1925).

54. 55 F2d 499, 510 (C. Cls. 1932), an IRC sec. 23(e) case involving worthless stock. Now here we have another new theory: That rent paid out is not deductible under *IRC* 23(a)(1)(A) unless *unintentionally* paid out.

55. *McDonald v. Com.*, 323 U. S. 57, 60 (1944) in which the radical difference between IRC 23(a)(1)(A) and IRC 23(e)(2) is pointed out. See also *Com. v. Wodehouse*, 337 U. S. 369, 393-4 (1949).

56. *U. S. v. White Dental Co.*, 274 U. S. 398, 401 (1927).

closed transaction".[57] And *IRC* 24(b), which again refers only to losses from the sale of capital assets, and *McWilliams* v. *Com.*[58] construing that section to cover intra-family stock sales even if made via the Stock Exchange, are now authority for the proposition that rent when paid to a family corporation under a written lease for four dwellings which the taxpayer subleased to strangers (62), is not "in reality, rentals" (40).

Of course the rent that this petitioner paid was properly deductible under *IRC* 23(a)(1)(A). He was obligated under a valid, enforceable lease which required such rental payments of him. In *Skemp* v. *Com.*, 168 F2d 598, 600 (7 Cir. 1948), the taxpayer transferred to a trustee a business building in which he had his offices and the balance of which he rented out to others, and on the same day took back a lease of the property at $6000 per year. The rent received by the trustee was paid to the taxpayer's wife. The taxpayer claimed as a business deduction the rent paid by him less the subrents received. The holding of the Tax Court that this $6000 was a mere "gratuity" was reversed on appeal—by Judge Minton of this Court—because: "While the taxpayer voluntarily created the situation which required the payments of rent, the fact remains that the situation created did require the payments. *There can be no question but what rent required to be paid is properly deductible* [under *IRC* 23(a)(1)(A)]". To the same effect are *Brown* v. *Com.*, ... F2d .... (3 Cir. 2/8/50); *Wodehouse* v. *Com.*, ... F2d ..... (2 Cir. 11/21/49). Even if this petitioner had been in complete control of the lessor corporation—which he was not (40, 105)[58]—the rent paid by him for the leasehold would still be deductible under *IRC* 23(a)(1)(A). *Nat. Carbide Corp.*

57. *Hort v. Com., supra,* at p. 33.

58. Cross exam of VH: "Mr. Clark, I tried to give you my best recollection. I told you it was unrefreshed. As a matter of fact, I have not been active personally in administering the affairs of the corporation. You are asking about things that occurred way back in 1935 and 1936. There have been annually filed returns of that corporation which disclose those facts which I believe you have in your possession. I don't have them and haven't access to them" (TR 40, p. 111-2, 118, 156).

v. *Com.*, 336 U.S. 422, 429 (1949); *Com.* v. *Culbertson*, 337 U.S. 733, 746 (1949). The rest of the reasons given by the Tax Court for its decision are similarly without merit.[59]

This "adjustment" of respondent and the trial thereon graphically demonstrate the result of (1) arbitrary notices of deficiency, prepared and mailed out to meet the deadline of the statute of limitations upon assessments of income taxes; (2) notices of deficiency and Tax Court answers which are intentionally noncommittal and aimed at being later anchored to some convenient IRC section; (3) failure of the Tax Court to require the issues to be clearly stated and its failure to remain within the issues that are clearly stated. Not only is the Tax Court decision obviously wrong as a matter of law but the spectacle made by the record on this issue is one of which all Americans must be truly ashamed. It should not be possible, particularly not after the enactment of *APA*, for a taxpayer to be required—under threat of imprisonment (74)—to submit to the inquisition[60] to which this petitioner was sub-

59. See petitioners' brief to Court of Appeals, of which a copy has been filed with the Clerk of this Court.

60. On the eve of the trial (28), petitioners were served with subpoenas calling for records that respondent had three times minutely examined, that he knew to be more than two hundred miles from the place of the trial and that had no conceivable relevance to the issues raised by the pleadings. Although the Rules of the Tax Court (RTC 44) required an application for a subpoena to state "sufficient facts to indicate that each item (to be produced) is reasonably necessary to establish the cause of action or defense of the applicant," respondent's application for this subpoena contained no facts whatever showing that the documents subpoenaed were pertinent to the matters at issue (28). Even at the trial the Tax Court permitted respondent to keep secret and undisclosed the relevance of the subpoenaed documents (TR 40, p. 252). It drew "unfavorable" presumptions from their non-production (40) although it is axiomatic that before any presumption arises from a failure to produce "some evidence of the contents of the documents must be introduced." 2 Wigmore, *Evidence* 187 (3rd ed. 1940). And the material sought by the subpoena must be shown to be competent, pertinent, relevant evidence in itself which, if produced, would establish a fact in issue. *Hann v. Venetian Blind Corp.*, 111 F2d 455, 459 (9 Cir. 1940); *People ex rel. Lemon v. Sup. Ct.*, 245 N. Y. 24, 34 (1927). At the trial, respondent's attorney had in his hands and was examining petitioners from the original annual income tax returns of the lessor corporation—the records of which he had subpoenaed—which would have enabled the petitioners to answer in detail all of respondent's questions regarding the affairs of the corporation (TR 40, p. 111, 250). But respondent's attorney refused "to disclose them, to produce them, or to permit them to leave my possession" (74). Although this was a violation of *Blair v. Oesterlein Machine Co.*, 275 U. S. 220, 227 (1927), the trial judge did not require respondent to permit the petitioners to examine these returns in court (74). The prior judge on the same trial had specifically ruled otherwise (56).

jected on this item. At no time during the trial were petitioners informed why respondent's questions were relevant (74), a question which every litigant is entitled to have answered.[61]

In affirming the Tax Court on this issue, the Court of Appeals has affirmatively sanctioned action by respondent and by the Tax Court which the decisions of this Court have uniformally held to be arbitrary, in excess of statutory power and authority, in violation of due process and void. Except for difference of subject-matter they are merely repetitions of the actions complained of in the foregoing Petition. On this issue also, the court below has determined the law contrary to the decisions of this Court and of other circuit courts; and contrary to the express provisions of *APA*.

The other "adjustments" made by respondent in the instant notices of deficiency and the holdings of the Tax Court and the Court of Appeals thereon can readily be shown to be of similar stripe.

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61. The following colloquy ensued when petitioners' attorney questioned the relevance of "all corporate records" (27) of the lessor corporation (74): "Miss Marx: I don't see where the affairs of the corporation—
The Court: What business have you to think whether it was important or not? You had an order from this court to produce them. What business have you to consider whether they were important or not?"